Witness CCS - 2

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of	**:**	**Docket No. 02-057-02**
Questar Gas Company for	**:**	**PRE-FILED DIRECT TESTIMONY OF**
an Increase in	**:**	**HUGH LARKIN, JR.**
Rates and Charges	**:**	**FOR THE COMMITTEE OF**
	:	**CONSUMER SERVICES**

August 30, 2002

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INTRODUCTION

17. WHAT IS YOUR NAME, OCCUPATION AND BUSINESS ADDRESS?

1. I am Hugh Larkin, Jr., a Certified Public Accountant licensed in the State of Michigan. I am the senior partner in the firm Larkin & Associates, PLLC, with offices at 15728 Farmington Road, Livonia, Michigan 48154.

17. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCIATES.

1. Larkin & Associates, PLLC is a Certified Public Accounting and Regulatory Consulting Firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorney generals, etc.). Larkin & Associates, PLLC has extensive experience in the utility regulatory field as expert witnesses in over 400 regulatory proceedings, including numerous electric, gas, telephone and water utilities.

17. HAVE YOU PREPARED AN EXHIBIT DESCRIBING YOUR QUALIFICATIONS AND EXPERIENCE?

1. Yes. I have attached Appendix I, which is a summary of my experience and qualifications.

17. ON WHOSE BEHALF ARE YOU APPEARING?

1. Larkin & Associates was retained by the Committee of Consumer Services (CCS or Committee) to analyze the reasonableness of Questar Gas Company's (QGC or Company) proposed $23 million revenue requirement increase and its proposed change to Commission policy regarding test year data.

Ms. Donna DeRonne will present the Committee's overall revenue requirement recommendation and the various schedules supporting that recommendation.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to support the current Commission policy of using an average historical test year. My testimony will supplement that of Daniel E. Gimble, who presented testimony in this docket regarding test year in the test year hearing held by the Commission. I believe Mr. Gimble eloquently stated the reasons why an average historical test year with known and measurable adjustments is appropriate. My testimony focuses more on the specific problems which Questar Gas claims result from the use of a historical average test year reflecting known and measurable adjustments.

Ms. DeRonne has provided the Commission with an alternative test year analysis using a projected 2002 average test year. While the Committee is not recommending the Commission adopt such a test year, we have shown it for illustrative purposes. I am also sponsoring adjustments to the projected test year for the Tight Sands Tax Credit and revenues associated with Geneva Steel.

QUESTAR'S ARGUMENT FOR A PROJECTED TEST YEAR

Q. WHAT DOES QUESTAR STATE ARE THE PROBLEMS WITH USING A HISTORICAL TEST YEAR IN THE INSTANT CASE?

A. On page 9 of the testimony of Company witness Alan K. Allred, he states: "QGC is firmly locked within the grip of an increasing investment and decreasing revenues per customer." The Company is apparently arguing the use of a historical test year does not reflect increasing investment, which the Company states is occurring to serve each additional customer. In other words, QGC is stating that for each additional customer added, the additional investment per customer is greater than the average investment per customer for existing customers. Additionally, the Company is stating that the revenue received per customer is decreasing.

Q. HOW WILL QGC'S PROPOSED SOLUTION OF USING A PROJECTED TEST YEAR WITH YEAR END RATE BASE (INVESTMENT) AFFECT RATEPAYERS AND THE INCREASING COST PER CUSTOMER ADDED?

A. The proposed solution of using a year end projected rate base will in effect spread the cost of increased investment for new customers to all customers. In other words, the cost causers of the increased investment are the new customers being added to the system at a higher incremental cost. The use of a projected year end rate base does not properly allocate investment to the cost causer. A projected year end rate base will spread any investment cost increase occasioned by new customers over all customers, thus masking the true cost of adding new customers.

In his direct testimony, CCS Witness McFadden discusses the substantial intergenerational cross subsidization which is occurring on the QGC system. He points out that there is a shortfall in contributions in aid of construction (CIAC) of $828 for each additional customer added to the QGC system. I am unaware of any other gas distribution company which does not require either the home builder, or the home buyer, to make contributions at least equal to the cost of mains and service lines to connect the additional residential customer.

In addition to the shortfall in CIAC to connect new customers, there is a shortfall in CIAC associated with excess footage contributions. The average cost of main construction in 2001 was $7.91[1] per foot. The average cost for service lines in 2001 was $13.82.[2] The Company has not updated the charge for excess footage for mains and service connections in over 11 years.[3] Thus, a substantial part of the problem the Company is experiencing with investment per

[1] CCS Data Request No. 10.38.

[2] Id.

[3] CCS Data Request No. 10.37.

new customer outstripping the embedded cost per customer, is the result of its failure to collect the appropriate level of contribution in aid of construction (CIAC) from new customers. The current charge for excess footage of main is $5.15. This compares with the $7.91 of actual costs. The 2001 cost per foot of line service is $13.82, while the Company charges an excess footage charge for service lines for ½-inch lines of $6.60 ranging up to $8.32 for a 2-inch line. The Company has estimated that an additional $2.3 million of revenue might have been generated had a more up-to-date excess footage charge for mains and service line footage charge been collected in 2001.[4]

Additionally, it is not clear if main extensions undertaken by the Company have been made on an economic basis. That is to say, the density of additional customers added with the extension of the main may not justify its current installation. If mains are installed with the anticipation that future growth will justify the current investment, then current ratepayers will be required to provide the carrying charge on this investment which will benefit future customers. This is an intergenerational cross subsidy which results from main extensions which are not currently economically justified. While this phenomenon may occur in a historical test year, it is exacerbated by the use of a projected test year with year-end rate base.

The use of a historical test year will limit the cross subsidization of future customers by current customers; the projected future additions will not be included in rates and paid for by current customers for the benefit of future customers. The Commission should require QGC to adjust CIAC for new service and CIAC for excess footage charges for mains and service lines to reflect the most current cost being incurred. Current tariffs allow for changes in the excess footage charges. Additionally, any main extensions should only be made after they have been

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[4]CCS Data Request No. 10.37

justified by a cost-benefit analysis showing that customer additions will fully support the main extension. If the Company can justify a main extension on other than a cost-benefit basis (e.g., it would be more advantageous to extend a main during a road construction project than it would be several years later), then the particular main should not be included in plant in service and should earn an AFUDC type return until the customer density on that main justifies its full revenue requirement.

Q. WHAT PROBLEMS ARE INHERENT IN USING A PROJECTED YEAR-END RATE BASE?

A. First of all, it is almost impossible to verify information used for projections. No one can project with any degree of accuracy either the cost or the number of customers who will be added to the QGC system in any particular month, let alone some 12 to 18 months in advance. Therefore, there is a problem with accuracy. This is further highlighted by QGC's significant revisions to its 2002 capital budget since its rate case filing. The second problem is that the use of a projected year-end rate base does not deal directly with the problem of increasing costs for each customer added. The use of a projected year-end rate base only exacerbates the problem because it masks the true costs of adding additional customers by spreading the cost to all customers and does not charge new customers the appropriate level of CIAC associated with their addition to the system.

A proper solution is to deal directly with the cost causation problem and analyze the underlying costs associated with main extensions and service hookups to insure that the CIAC charge is at an appropriate level. This will have two effects. First, it will charge the appropriate customer (that is the new customer) with the cost of adding them to the system. Second, it will curtail growth on the system which is uneconomic. That is, customers who would not choose gas as a source of fuel for optional appliances, such as pool heaters, barbecues, gas lamps, spa heaters and patio heaters, would think twice about adding those appliances if service was not already available at the residence. Use of a year-end rate base and year-end projections allows the Company to reduce the cost of uneconomic usages because there is a greater cross subsidization of new customers by embedded customers which allows the Company to charge lower CIAC costs.

Q. PLEASE DISCUSS THE NEXT PROBLEM IDENTIFIED BY THE COMPANY.

A. The second problem identified by QGC and Mr. Allred's testimony is "decreasing revenue per customer."

There were at least three factors that affected the 2001 decatherm per customer consumption, which explains the majority of the decline in customer consumption. These three factors are:

1. The recession, which started in March 2001 and continued into April 2002, and is still impacting the economy today;
2. The $167 million increase in the Company's natural gas rates, which became effective January 1, 2001 combined with an increase of $63 million in 2000 that continued through most of the year.[5]
3. Reduced consumption as a result of the utilization of more efficient gas appliances and conservation measures.

The Company has projected a continued decrease in gas consumption in the future projected test year. These projections were based on the trend through 2001, which included a recession and a gas price spike. Neither of these factors have been removed by the Company in its

[5]This increase of approximately $230 million was subsequently reduced as a result of two pass-through decreases totaling $178 million in late 2001. Pass-through rates are still about $52 million higher than they were prior to October 2000.

projection of customer consumption. The use of the historical test year utilizing actual weather normalized consumption will not build the recession and the impact of the gas cost spike into rates. The Company's use of trending of consumption inappropriately amplifies the effects of these events which impacted customer consumption on a temporary basis.

It should also be noted that the reduction in customer consumption as a result of more efficient appliances and conservation measures is not a trend that will last indefinitely. It is difficult to measure the effects of efficient appliances and conservation measures on gas consumption. However, the Commission should not assume that a trend which includes a recession and a gas price spike can fairly represent average customer consumption in the future.

Q. IS IT YOUR OPINION THAT THE RECESSION IS STILL AFFECTING CUSTOMER ATTITUDES IN THE YEAR 2002?

A. Yes. The recession of 2001/2002 has left consumers with a cautious attitude. Economic growth, tepid at best, is evidenced by low job growth and a lack of confidence in the stock market. Moreover, the possibility of a double-dip recession looms on the horizon.

Q. HASN'T QGC'S GAS COST DECLINED SINCE THE INCREASE IN JANUARY 2001?

A. Yes, it has, but it is still higher than at the beginning of the year 2000. The 2000 increase of approximately $63 million and the January 1, 2001 increase of $167 million were reduced on in pass-through fillings in late 2001 by approximately $178 million. That still leaves an increase in gas costs of approximately $52 million which is still reflected in consumers' bills.

Q. YOU HAVE STATED THAT THE HISTORICAL TEST YEAR REFLECTS BOTH THE EFFECTS OF THE RECESSION AND THE GAS PRICE SPIKE ON GAS CONSUMPTION. SHOULDN'T THOSE MAJOR EVENTS BE REMOVED IN

ESTABLISHING BASE RATES?

A. Yes, they should. If one used either the historical or a projected test year, those events should be removed in establishing customer usage levels. However, I am unaware of any methodology which one could use other than a guess as to what effect the recession and the gas price spike have had on customer consumption. There is no doubt, however, that these events have affected gas usage levels and that the test year would be impacted. However, the 2002 test year takes the actual reduction in consumption in 2001 and trends it out further in time. As I previously stated, the use of a projected test year magnifies the effect of the recession and the gas price spike, which is not appropriate.

Q. YOU HAVE ALSO STATED THAT THE TREND IN REDUCED CONSUMPTION WAS IMPACTED BY MORE EFFICIENT GAS APPLIANCES AND CONSERVATION MEASURES. WILL THAT TREND CONTINUE INTO THE FUTURE?

A. No one knows. At some point in time diminishing returns will set in.

Q. HOW CAN THE COMMISSION BE ASSURED THAT THE GAS CONSUMPTION PER CUSTOMER PROPOSED BY THE USE OF THE HISTORICAL TEST YEAR IS NOT OVERSTATED?

A. The historical test year includes at least two significant events which are temporary. These are the recession and the 2001 gas price spike. Gas consumption, based on historical test year 2001, reflects both of these events, and is thus understated to some extent. By using a projected test year, the Company has trended the effects of these events even further and has reduced consumption in the 2002 projected test year. Accordingly, if the Commission adopts a 2002 test year, the Company's adjustment to reflect the further decline in consumption should be removed or, if possible, adjusted to remove the effect of the recession and price spike.

Q. DOES PRICE REALLY HAVE AN IMPACT ON GAS CONSUMPTION? THAT IS, DO RATEPAYERS CURTAIL CONSUMPTION AS PRICE INCREASES?

A. Yes, they do. The Company has acknowledged that in at least one response regarding the Company's failure to increase charges for service line and main line extensions. The Company stated in response to the Committee's data request, No. 10.36, the following:

> 10.36 Provide the Company's best estimate of the impact of the failure to update the price of pipe charged to customers for service lines and main lines on revenues recorded during the twelve months ended December 31, 2001.
>
> Answer: Using actual 2001 cost per foot of main the service lines and the 2001 footage above the no-charge allowances, QGC has estimated that $2.3 million of revenues might have been generated. <u>This assumes that the price elasticity of demand is zero, that the percent of refunds associated with mains would stay the same, and that the footages installed would remain the same as well. These assumptions do not accurately reflect the likely response to higher charges, and it could be expected that, as the charge per foot is increased, the amount of footage on which the charge is applied would decrease.</u> However, QGC has conducted no further analysis of these effects. (Emphasis added)

The Company has acknowledged that the increase in price reflecting actual cost for installing main and line extensions would most likely cause the amount of footage installed, which could be charged for, to decrease. Obviously, this is a benefit to the Company, since it will decrease the investment required to add customers. On the other hand, to take a period which includes a recession and a gas price spike and trend that into decreased consumption to justify higher prices (which will again cause lower consumption) is, in effect, a self-fulfilling prophecy in that higher prices, in and of themselves, will cause lower consumption.

Q. HAS QGC STATED THAT THE COMMISSION'S USE OF A HISTORICAL TEST YEAR HAS FORCED THE COMPANY TO REDUCE SERVICES?

A. Yes, it has. Mr. Allred's testimony, on page 7, line 15, states: "This purposeful rejection of future or projected test years has forced the Company to undertake major service reductions in order to have an opportunity to earn its allowed rate of return."

Q. HAS QGC PRESENTED EVIDENCE WHICH SHOWS WHAT SERVICES HAVE BEEN REDUCED AND THEIR EFFECT ON CONSUMERS?

A. To my knowledge, they have not. There has been a general theme in Mr. Allred's testimony that ratepayers have been harmed because of the use of historical test years. The Company has not presented evidence of this fact and has just made statements that services have been reduced, but has not presented any analysis which justifies these statements. Mr. Allred also implies that the early retirement plan, which was initiated by the Company after the Commission authorized the last rate increase, was occasioned by the use of historical test years. He stated in his testimony: "Also as a non-recurring cost reduction, the Company took the major one time step after the last general rate order to reduce costs by offering an early-retirement program."

Q. IS MR. ALLRED CORRECT? IS THE COST REDUCTION ASSOCIATED WITH AN EARLY RETIREMENT PROGRAM A NON-RECURRING COST REDUCTION?

A. I do not believe it is. After one accepts an early retirement, their salary is no longer included as an operating expense. Therefore, it is a permanent reduction. I think Mr. Allred acknowledges that further in his testimony when he says, "This singular step reduced the Company's O&M cost by $5.1 million on an annualized basis." Early retirement programs are common in the utility industry. PacifiCorp has had two early retirement programs that I can recall. Companies on the East Coast, such as, Connecticut Natural Gas and Southern Connecticut Gas, also have had early retirement programs to reduce O&M expenses. These cost reductions were not blamed on the Commission, but were the normal undertaking of any utility with an older workforce with high salaries. The workforce reductions are a normal occurrence. The gas industry has been experiencing reduction in employee levels for a number of years. The Company's early retirement program is neither unique or unusual.

Q. MR. ALLRED STATES AT PAGE 9 OF HIS TESTIMONY THAT WHEN A HISTORICAL TEST YEAR WITH KNOWN AND MEASURABLE ADJUSTMENTS IS USED THE RESULT IS "AN INSTANT MISMATCH OCCURS IF THE UTILITY EXPERIENCES MATERIAL CHANGES IN COSTS OR REVENUES." HAS MR. ALLRED SHOWN WHICH MATERIAL CHANGES IN COSTS OR REVENUES WILL OCCUR AS A RESULT OF A HISTORICAL TEST YEAR?

A. No, he has not, but he has implied that the cost of utility plant and the declining consumption per customer results in the "material changes." I have addressed the increase in plant as a result of adding customers at a higher than embedded cost, and how those costs either ought to be charged to the new customer or an AFUDC rate should be charged until the expansion is cost justified. Mr. Allred's solution would be to engage in speculation as to what changes might occur at least a year in advance and factor those into the revenue requirement. This, of course, violates the known and measurable standard and shifts all possible risks from Company stockholders to ratepayers.

TIGHT SANDS TAX CREDIT

Q. THE COMMITTEE IS RECOMMENDING THAT THE COMMISSION ADHERE TO ITS POLICY OF USING A HISTORICAL TEST YEAR WITH AVERAGE RATE BASE, IS THAT CORRECT?

A. Yes, it is.

Q. MS. DERONNE HAS PROVIDED AN ALTERNATIVE TEST YEAR ANALYSIS USING A 2002 AVERAGE TEST YEAR, IS THAT CORRECT?

A. Yes, it is.

Q. ARE YOU SPONSORING ANY ADJUSTMENTS IN THE ALTERNATIVE 2002 AVERAGE TEST YEAR BEYOND THE REMOVAL OF THE COMPANY'S ADJUSTMENT TO FURTHER REDUCE CONSUMPTION?

A. Yes, I am.

Q. WOULD YOU DISCUSS THE FIRST OF THOSE ADJUSTMENTS, THE ADJUSTMENT FOR TIGHT SANDS TAX CREDIT?

A. Yes. The Company has removed from the 2002 projected test year a credit which it receives under the Internal Revenue Code for Section 29, Tax Credits. This credit was removed under the theory the current tax law, which allows for these credits, ends at December 31, 2002. Congress is currently considering an extension in some form of these tax credits. The Company has indicated in DPU Data Request 5.4 that it will modify the test year calculations sponsored by QGC when the tax credits pass Congress. I am proposing that the tax credits currently in effect be included in the projected test year, since it is clear that Congress is considering an extension of these credits. If Congress does not extend the credits, then the Commission can remove this adjustment. However, it is more appropriate to reflect what the Company is currently receiving in credits until such time that it is clear that these credits will not be received. The Commission can then remove them from the revenue requirement calculation if it chooses to adopt a 2002 test year.

17. WHAT IS YOUR RECOMMENDATION?

1. I recommend reinstating the $2.65 million to the 2002 test year.

<u>GENEVA STEEL</u>

Q. ARE YOU PROPOSING AN ADJUSTMENT TO REFLECT GENEVA STEEL REVENUES IN THE 2002 TEST YEAR SHOWN IN MS. DERONNE'S TESTIMONY?

A. Yes, I am. QGC has adjusted actual 2001 volumes to remove Geneva Steel (Geneva). The Company has also removed Geneva's consumption from the 2002 test year. In January 2002, Geneva filed for Chapter 11 Bankruptcy Protection. It had suspended operations and laid-off 1,400 employees in November 2001.

Geneva Steel has applied to Deutsche Bank, for a loan which would allow it to emerge from bankruptcy and resume operations. Under Geneva's reorganization plan the existing plant would resume production and a new electric arc furnace would be built. PacifiCorp and Geneva Steel are currently negotiating an electric supply agreement for energy necessary to operate both resources. Based on the anticipation of a positive outcome for Geneva Steel, it would be appropriate to include gas consumption at the 2001 level in a projected test year.

17. WHAT IS YOUR RECOMMENDATION?

1. DNG revenues in the amount of $785,000 should be included in the 2002 projected test year.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.